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TAX TREATMENT OF CCC COMMODITY CERTIFICATES
IMPACT OF REV. RUL. 87-17

by
Richard D. Duvick and Paul L. Wright 1/

On 2/17/87 IRS issued Rev. Rul. 87-17 which prescribes a method for reporting the tax consequences of generic commodity certificates. This ruling leads to a different tax result for farmers who used certificates in conjunction with CCC loans and carried the grain over to 1987, than resulted from previous interpretations. The results can be especially severe for a farmer who treats CCC loans as loans for tax purposes.

Rev. Rul. 87-17 asserts that all participants in the 1986 Government Program have the following 1986 taxable income:
1) Face value of all commodity certificates received in 1986.
2) Full value of all CCC loans redeemed using CCC commodity certificates (regardless of whether the certificates were issued or purchased.)

Point 1 is consistent with prior rulings and interpretations. However, point 2 is based on an October, 1986, USDA regulation that any loan redeemed with CCC certificates is a "forfeiture". The full loan amount redeemed with certificates is thus taxable income at the date of forfeiture, whether you treat loan amounts for income tax purposes as income or as a loan.

How does this differ from prior interpretation? Our previous analysis treated the certificates as a form of payment for redeeming loans. Thus, no income was realized until the grain was sold or forfeited, unless loans were reported as income. However, the difference between the face value or purchase price of certificates and the amount of loan redeemed was treated as income, on the date of redemption.

What farmers are affected by this ruling? The ruling only affects farmers who: 1) redeemed loans with certificates in 1986, and 2) held that grain to 1987 for sale or feed. However, the tax impact may be either positive or negative, depending upon how they treat CCC loans for tax purposes. Farmers who report loans as loans may owe additional tax for 1986, while those who treat loans as income may find their income (and taxes owed) to decrease for 1986. Since most farmers treat CCC loans as loans, many corn producers would likely have more taxable income in 1986 than anticipated -- possibly creating severe tax problems for these farmers.

1/ Extension Economists in the Department of Agricultural Economics and Rural Sociology, The Ohio State University, Columbus. June 11, 1987.

Comparison of Taxable Income Impacts for A Farmer Who Received $12,000 of Certificates For 1986 Program Participation

Following are 2 examples which are variations of the example that was in the 1986 Ohio Farm Income Tax School workbook. The workbook analysis was used in our 1986 tax workshops and was the basis of a January, 1987 article in the "Ohio Farmer" magazine. The following material is presented slightly differently and some additional assumptions of facts were made in order to compare the previous interpretation with IRS Rev. Rul. 87-17.

Generally, farmers manage grain sales in such a way that only a single crop is sold in any one year. A farmer who sells the crop in the year after the year it was produced, would typically: a) treat loans as loans so the income is not reported until the grain is sold or forfeited; or b) wait until the next tax year to take out the loan if he treats loans as income. However, Rev. Rul. 87-17 defines taxable income to be created at the time CCC loans are redeemed with certificates, regardless of what the farmer intended.

FACTS 1: Frank pledged 9,000 bushels of his 1986 corn crop as collateral for a CCC loan of $16,400. He treats CCC loans as loans for tax reporting purposes, but the results are also shown for treating CCC loans as income. For participating in the 1986 Feed Grain Program, Frank received CCC certificates with a face value of $12,000. Frank was able to use these certificates to pay off the loan in full. Frank sold the 9,000 bushels in 1987 for $17,000. What is the marginal impact on taxable income and taxes for 1986-7 for the loans redeemed with certificates?

This example illustrates a producer near the top of the $50,000 payment limitation with 25% paid in 1986 as generic commodity certificates. In this example, the assumed county posted price was $.49 per bushel under the loan rate. The impact is more dramatic if the advance payments on the 1987 Program and the possibility of purchasing certificates from others was taken into account. (See Facts 2.)

In each of the 4 situations shown, the $12,000 face value of certificates issued to the producer is reported as 1986 taxable income. The first analysis assumes treating CCC loans as a loan. In the original interpretation, the only additional 1986 taxable income is the $4,400 profit on using the certificates to redeem the loan. Thus total taxable income is $16,400 in 1986, and $17,000 in 1987 upon sale of the grain. However, following Rev. Rul. 87-17, 1986 taxable income rises to $28,400. If the farmer's combined tax rate (federal, state and self-employment tax) equals 30%, the additional $12,000 of 1986 income results in an additional tax liability of $4,000.

Applying the same assumptions and Rev. Rul. 87-17 to the situation where the farmer treats the loan receipts as income in 1986 would defer $4,440 of income to 1987 and result in $1,320 less tax owed in 1986. This comes about since there is no profit reported on use of the certificates to redeem a loan. Instead, it is reflected in a lower basis of the grain carried over, and defers income to the next year.

A) 1986 TAX WORKBOOK INTERPRETATION:

TAXABLE INCOME, 1986 CROP:	Treats CCC Loans As: A Loan	Income
On 1986 Tax Return:		
Face value of own cert's	$12,000	$12,000
CCC loan as income	-	$16,400
Profit on use of cert's.	$4,400	$4,400
Sale or forfeit of grain	-	-
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TOTAL 1986 taxable income	$16,400	$32,800
Tax basis in grain, 12/31/86	$0	$16,400
On 1987 Tax Return:		
Sale of grain($17,000-basis)	$17,000	$600
	=======	=======
TOTAL 1987 taxable income	$17,000	$600
TOTAL INCOME: Cert's + '86 CROP	$33,400	$33,400

B) IRS REV. RUL. 87-17 INTERPRETATION:

TAXABLE INCOME, 1986 CROP:	Treats CCC Loans As: A Loan	Income
On 1986 Tax Return:		
Face value of own cert's.	$12,000	$12,000
CCC loan as income	-	$16,400
Profit on use of cert's.	$0	$0
Sale or forfeit of grain	$16,400	-
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TOTAL 1986 taxable income	$28,400	$28,400
Additional tax owed at 30%	**$4,000**	**($1,320)**
Tax basis in grain, 12/31/86	$12,000	$12,000
On 1987 Tax Return:		
Sale of grain($17,000-basis)	$5,000	$5,000
	=======	=======
TOTAL 1987 taxable income	$5,000	$5,000
TOTAL INCOME: Cert's + '86 CROP	$33,400	$33,400

This represents only the marginal impact on taxable income, basis and change in tax liability from various assumptions about tax treatment of CCC loans redeemed with generic commodity certificates.

FACTS 2: Carl received a $100,000 loan on his 1986 crop. He received $12,000 of certificates and purchased additional at a cost of $70,000. These certificates allowed Carl to pay off the entire loan. Carl sold the 1986 crop in 1987 for $97,000. What is the marginal effect of this loan on his 1986-7 taxable income?

A) 1986 TAX WORKBOOK INTERPRETATION:

TAXABLE INCOME, 1986 CROP:	Treats CCC Loans As: A Loan	Income
On 1986 Tax Return:		
Face value of own cert's	$12,000	$12,000
CCC loan as income	-	$100,000
Profit on use of cert's.	$18,000	$18,000
Sale or forfeit of grain	-	$0
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TOTAL 1986 taxable income	$30,000	$130,000
Tax basis in grain, 12/31/86	$0	$100,000
On 1987 Tax Return:		
Sale of grain($97,000-basis)	$97,000	($3,000)
	=======	=======
TOTAL 1987 taxable income	$97,000	($3,000)
TOTAL INCOME: Cert's + '86 CROP	$127,000	$127,000

B) IRS REV. RUL. 87-17 INTERPRETATION:

TAXABLE INCOME, 1986 CROP:	Treats CCC Loans As: A Loan	Income
On 1986 Tax Return:		
Face value of own cert's.	$12,000	$12,000
CCC loan as income	-	$100,000
Profit on use of cert's.	$0	$0
Sale or forfeit of grain	$100,000	$0
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TOTAL 1986 taxable income	$112,000	$112,000
Additional tax owed at 30%	$24,600	($5,400)
Tax basis in grain, 12/31/86	$82,000	$82,000
On 1987 Tax Return:		
Sale of grain($97,000-basis)	$15,000	$15,000
	=======	=======
TOTAL 1987 taxable income	$15,000	$15,000
TOTAL INCOME: Cert's + '86 CROP	$127,000	$127,000

Farmers who treat CCC loans as loans and who purchased certificates to secure additional marketing profits, may have a large added tax, since they sold an "extra crop" in 1986, as above.

Background On Generic Commodity Certificates

The generic commodity certificates issued in 1986 were a new variation on government compensation to farmers. The certificates represented partial payment for land diversion and deficiency payments for participation in the 1986 Government Program. The certificates provided a market mechanism to trigger release of government stocks into the open market. Producers could redeem certificates at face value for cash at ASCS offices. However, additional cash could be realized by using certificates to redeem commodities under CCC loans, or by selling them to others. One variation of this activity was described in the popular press as "PIK and Roll". However, no guidance was provided by IRS or USDA as to the tax consequences of the certificates.

Farmers perceived the use of certificates as another medium of exchange to pay off a loan. In a forfeiture, farmers receive a copy of the original loan statement, showing that the loan was satisfied by forfeiture of the grain, and the producer must arrange to deliver the grain to a site designated by ASCS. In a redemption, the farmer receives a CCC-500 form, showing the amount of principle paid, quantity of commodity redeemed, and any interest paid, plus the farmer regains title to the commodity. It appears that ASCS offices used the CCC-500 form and treated certificate payments as loan redemptions.

Professors Allen Bock and Philip Harris, agricultural attorneys at the University of Illinois and University of Wisconsin, respectively, researched the tax issues after consulting with both USDA and IRS officials. Their interpretations were shared with IRS personnel who issue IRS Publication 225, The Farmers Tax Guide. Bock and Harris arrived at the following as a result of their analysis of the CCC generic commodity certificates:

1) The face value of the commodity certificate is taxable income in the year received by the farmer.
2) If the certificate is redeemed at ASCS, payment received is simply face value of the certificate.
3) If the certificate is sold to others, additional gain or loss is realized at the date of sale. (Most certificates sold at a premium of 5 to 25 percent.)
4) If the certificate is used to redeem a CCC loan, additional gain or loss is realized at the date of redemption. This is because the face value of the certificate was divided by the posted county price to determine a quantity of commodity. Then an equal quantity under loan was considered redeemed. For corn, this meant 20 to 60 cents per bushel profit from using certificates to redeem the loan.
5) Tax treatment of CCC loans as income or as loans follow the long standing rules of IRC Sec. 77, whether redemption was made with cash or with CCC certificates.
6) Tax basis of the grain is not affected by use of certificates.

This analysis was in the 1986 Farm Income Tax Schools Workbook, used in 40 states with about 40,000 tax preparers.

Comments:

Treatment of CCC loans paid with certificates as forfeitures found in Rev. Rul. 87-17 is based on final regulations issued in October,1986 by USDA. They were issued to avoid imposing penalties on producers who wanted to use certificates to redeem commodities in the 3 Year Reserve, (and encourage such actions). Other methods are available to accomodate such a result, but this was the one implemented.

Rev. Rul. 87-17 causes income to be reported at an earlier time for the taxpayer who treats CCC loans as a loan. Many farmers used Generic Commodity Certificates with no intention of creating additional taxable income on their grain in 1986. For a taxpayer who reports CCC loans as income, the difference between face value and redemption value of CCC Certificates is a downward adjustment of basis, rather than as additional proceeds for participation in the 1986 Government program. This may distort income by deferring the profit on certificates to a later period.

The interpretation based on the Bock and Harris analysis does not cause distortions in the income, due to the use of CCC certificates to redeem loans, but simply allows producers to treat loans in the usual manner and continue to report income as in prior years. We feel this is an equitable procedure to follow in the tax treatment of commodity certificates.

Actual cash flow will depend on the individual farmer's circumstances. USDA's intent was to reduce grain stocks through the issuance of Generic Commodity Certificates. They have been successful in meeting this policy goal. It seems unlikely that there was any intent to cause economic hardship for producers. But in general, the interpretation under Rev. Rul. 87-17 limits the ability to avoid sharp swings in levels of income and to continue to report taxable income in the intended year. And they fail to address additional questions related to Generic Commodity Certificates, including the use of purchased certificates.

Since most farmers treat CCC loans as a loan, many corn producers would likely have more taxable income in 1986 than anticipated -- possibly creating tax problems for these farmers. We feel that the USDA ruling stating that payment of CCC loans with certificates are forfeitures is inappropriate and should be reexamined. Several U.S. Senators and Congressman have been contacted about this concern and requested to seek a reversal of this ruling, either by modifying the USDA regulation or by legislative action. Most farm tax returns were due on March 2, 1986. Affected farmers need to file amended returns, unless they decide to wait until this issue is resolved.

[¶ 54,708] **RevRul 87-17 (IR-87-13). OTHER INCOME ITEMS—Commodity credit loans—time for reporting proceeds of loans.** IRS has issued ruling explaining federal income tax consequences of farmer's receipt of generic commodity certificates, pledging of gain to secure and terminate of Commodity Credit Corp. loans, use of certificates to repurchase grain pledged, and subsequent sale of grain. *Ref.* ¶7904(25). Sec. 77.

IR-87-13—In response to numerous inquiries the Internal Revenue Service today [2-17-87] issued a ruling concerning the taxability to farmers of generic commodity certificates.

The ruling explains the federal income tax consequences of the receipt of generic commodity certificates, the pledging of grain to secure a loan from the Commodity Credit Corporation and the termination of that loan, the use of the certificates to repurchase the grain that was pledged and the subsequent sale of the grain.

Revenue Ruling 87-17, is attached and will be published in the Internal Revenue Bulletin No. 1987-9, dated March 2, 1987.

Part I

Section 61.—Gross Income Defined.

26 CFR 1.61.1: Gross Income (Also Sections 77, 1001; 1.77-1, 1.1001-1.)

RevRul 87-17

Issue

What are the federal income tax consequences of (1) the receipt of generic commodity certificates, (2) the pledging of grain to secure a loan from the Commodity Credit Corporation and the termination of that loan, (3) the use of the certificates to repurchase the grain that was pledged, and (4) the subsequent sale of the grain.

Facts

A is a farmer using the cash receipts and disbursements method of accounting and filing federal income tax returns on a calendar year basis. In 1986, pursuant to government deficiency and diversion programs, *A* received generic commodity certificates with a total face value of $10,000. Also in 1986, *A* borrowed $12,000 from the Commodity Credit Corporation (CCC), pledging grain to the CCC as security for the nonrecourse loan. *A* currently deducted all expenses incurred in producing grain and had a zero basis in the grain that was pledged.

Later in 1986, when the value of the grain securing the nonrecourse CCC loan had fallen to $10,000, *A* notified the CCC that the loan would be terminated and that the commodity certificates would be used to reacquire the grain. Under U.S.D.A. regulations, *A* was treated as having sold the grain to the CCC for an amount equal to the $12,000 loan and as having used the amount received to repay the loan. *A* then used the certificates to repurchase the grain from the CCC for its current value of $10,000.

In 1987, *A* sold the grain for $13,000.

Situation 1: Pursuant to section 77 of the Internal Revenue Code, *A* elected to treat the proceeds of the CCC loan as income in 1986, the year received.

Situation 2: A did not make the election under section 77.

Law and analysis

Section 61(a) of the Code provides that gross income means all income from whatever source derived, including gross income derived from business.

Section 1.61-4 of the Income Tax Regulations provides, in relevant part, that a farmer using the cash receipts and disbursements method of accounting shall include in gross income the amount of cash and the value of merchandise or other property received during the year from the sale of produce raised by the farmer and all subsidy and conservation payments received which must be considered as income.

Section 77(a) of the Code provides that amounts received as loans from the CCC shall, at the election of the taxpayer, be considered as income and shall be included in gross income for the taxable year in which received. This section is intended to permit a taxpayer to avoid income recognition in a taxable period later than that in which the production expenses were deducted. S. Rep. No. 648, 76th Cong., 1st Sess. 8 (1939), 1939-2 C.B. 524, 529.

Section 1001 of the Code provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 of the Code.

Section 1.1001-2 of the regulations provides, with certain exceptions, that the amount realized from a sale or other disposition of property, including a transfer of property in satisfaction of liabilities to which it is subject, includes the amount of liabilities from which the transferor is discharged. *See also* section 1.1001-2(c), Example (7); section 7701(g) of the Code. RevRul 76-111, 1976-1 C.B. 214, holds that a transfer of assets in consideration of a cancellation of indebtedness is equivalent to a sale upon which gain or loss is recognized in the amount of the difference between the basis of the assets transferred and the amount of the indebtedness that is cancelled in consideration for the transfer.

Section 1012 of the Code provides that the basis of property shall be the cost of such property. Section 1016(a)(8) of the Code requires that the basis of property pledged to the CCC as collateral for a loan be increased by the amount of the loan proceeds, if the proceeds were included in gross income in the year received pursuant to an election under section 77 of the Code.

RevRul 75-57, 1975-1 C.B. 141, holds, in the case of a cotton producer who did not elect under section 77 of the Code to have loan proceeds from the CCC included in gross income when received, that the producer is taxable in the year in which the producer's liability on the loan is discharged by a transfer to the CCC of the cotton pledged as security for the loan.

In RevRul 80-19, 1980-1 C.B. 185, a cash method farmer obtained a loan from the CCC pledging that year's crop as collateral. The farmer elected under section 77 of the Code to include the loan proceeds in gross income. The next year the loan was repaid and the crop pledged as collateral was redeemed. Thirteen months later the redeemed crop was sold at a price that exceeded the amount of the loan. The ruling states that if an election is made under section 77 of the Code, the crop is treated as being sold when it is pledged as collateral for the loan and is treated as being repurchased when it is redeemed by repayment of the loan.

Under section 61(a) of the Code and section 1.61-4 of the regulations, *A*'s receipt of the commodity certificates in 1986 gave rise to $10,000 of income in that year. Under section 1012 of the Code, *A* had a basis of $10,000 in the certificates.

A also has income of $12,000 in 1986. In *Situation 1, A* elected to include the proceeds of the CCC loan in income. Although under U.S.D.A. regulations this transaction is a loan, for federal income tax purposes the grain is treated as having been sold when it was pledged as collateral for the loan. RevRul 80-19, supra. Thus, *A* had $12,000 of income from the sale of the grain at the time it was pledged and no additional income when the loan was terminated. See section 1016(a)(8) of the Code. *In Situation 2, A* did not make the section 77 election, and therefore, unlike *Situation 1,* the transaction is not viewed as a sale for federal income tax purposes. *A* terminated the loan later in 1986 when the grain had fallen in value to $10,000. U.S.D.A. regulations treat this transaction as a sale of the grain to the CCC for $12,000 being used to repay the loan. For federal income tax purposes, the substance of the loan termination transaction is that *A* forfeited the grain pledged as collateral in full satisfaction of the nonrecourse loan. So viewed, the transfer of the grain in return for the discharge of the $12,000 indebtedness is treated as a sale of the grain for that amount. Section 1.1001-2 of the regulations, RevRul 76-111, supra, and RevRul 75-57, supra. Thus, *A* had $12,000 of income from the sale of the grain at the time the loan was terminated.

A's use of the commodity certificates having a basis of $10,000 to repurchase the grain worth $10,000 from the CCC resulted in no gain on disposition of the certificates. Under section 1012, *A* had a cost basis of $10,000 in the grain purchased.

A's sale of the grain in 1987 resulted in a gain of $3,000, the amount realized ($13,000) over *A's* basis ($10,000).

HOLDING

In both *Situation 1 and Situation 2, A* had income of $10,000 on the receipt of generic commodity certificates, $12,000 on the sale of grain to the CCC, and $3,000 on the sale of the repurchased grain. In neither situation does *A* have income from the use of the commodity certificates to repurchase grain from the CCC.